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SUBJECT: BRAZIL - THE MICROECONOMIC REFORM AGENDA

REF: A) 04 BRASILIA 3115  
B) BRASILIA 043  
C) BRASILIA 210  
D) BRASILIA 417  
E) BRASILIA 447  
F) BRASILIA 387  
G) BRASILIA 024

[11.](#) (SBU) Summary: In contrast to Brazil's recent outstanding macroeconomic performance, its progress on the microeconomic and structural reforms necessary to sustain healthy growth levels has been mixed. The GoB has a well-articulated reform agenda and continues to push key measures through Congress. It obtained congressional approval in the closing moments of 2004 for laws allowing for the creation of public-private partnerships (PPPs) in infrastructure investment, reform of the bankruptcy code, an innovation incentives law and judicial reform (ref B). President Lula, however, has named only four reform priorities for 2005: a second round of tax reform to unify state-level VAT tax rates; labor union reform; reform of the University system; and, regulation/implementation of the PPPs. While not singled out as a priority by Lula, many other reforms, including Central Bank autonomy and a framework law to govern regulatory agencies (ref E), remain on the agenda. The surprise defeat of Lula's candidate in elections for Speaker of the Chamber of Deputies (ref F) may complicate relations with the Congress and contribute to the slimmed down set of presidential reform priorities for the year. Nevertheless, the GoB views reform as a long-term process in which it is important not to lose momentum and will look for alternate ways to advance more technical level measures. End summary.

[12.](#) (SBU) It is a matter of gospel among the GoB economic team that Brazil needs to sustain healthy growth levels for some time to begin to make an impact on entrenched poverty and its skewed income distribution. What the sustainable rate of economic growth is, however, remains much debated. Central Bank Chairman Meirelles put the rate at 3% to 3.5% in a December conversation with the Ambassador (ref A). More optimistic analysts put the number closer to 4%. But, all recognize there is a need for continued reform to boost productivity and, thereby, the sustainable growth rate. The GoB's microeconomic reform agenda aims to, among other things, improve the functioning of credit markets, promote long terms savings, reduce bureaucratic hurdles for businesses, cut payroll taxes and decrease judicial uncertainty. While pieces of this well articulated agenda have already been implemented, one contact, Mauricio Mendonca of the National Confederation of Industries (CNI), observed to us that political realities have frequently reduced the ambition of GoB's reform proposals and delayed their passage.

Recent Reforms: PPP, Bankruptcy Law and Judicial Reform  
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[13.](#) (SBU) The Lula administration championed PPPs as the centerpiece to its plans to increase infrastructure investment. The idea is to make marginally profitable commercial investments in infrastructure, which nevertheless have a high societal return, more attractive. This can be accomplished by, among other things, guaranteeing a minimum return, providing an operating subsidy or fronting part of the initial investment, including through contributions in kind. The law was approved December 22, 2004 and the GoB hopes to issue implementing regulations and launch the first projects for bids in late 2005. Some observers (including some within the GoB - ref A) have argued that the GoB has overemphasized PPPs and should instead focus on projects that would be profitable as straight concession contracts. In any event, implementing regulations remain to be elaborated. The business community, according to Mendonca, believes the Congress improved the PPP

legislation that the GoB submitted, but nevertheless feels it had taken unduly long to do so, delaying implementation for the sake of marginal improvements.

14. (U) The Congress passed on December 13 a major overhaul of the bankruptcy code. Modeled on Chapter 11 of the U.S. bankruptcy statutes, the law makes it possible for companies in financial straits to negotiate restructuring arrangements with their creditors outside of the courtroom. Resorting to bankruptcy under the previous code was, effectively, a death sentence. The new code gives higher priority to commercial creditors and limits labor claims, all of which should enhance creditors' ability to recover their money. The reform ultimately may have a significant impact on Brazil's infamously high lending spreads (on average about 24 percentage points above the benchmark SELIC rate for businesses and 45 points for individuals), but it remains to be seen how the code holds up in the court system.

15. (U) Another frequently cited culprit for high lending spreads in Brazil is the uncertainty that individual judges will enforce creditor claims. The judicial reform enacted in December 2004 should, over time, begin to improve the situation. Key among the several improvements enacted is the concept of binding precedent (ref G). Decisions by appeals courts or the Supreme Court will be binding on lower courts in future cases where the same point of law is in question and when the case was decided by a super-majority of the judges. In addition to reducing uncertainty, this should help reduce the workload on the overburdened courts.

16. (U) Various bills as an innovation law and an industrial policy law, Law 10.973 of December 2, 2004 enacts a series of measures to spur investment in research and development. These measures include, among other things, authorizing financial markets to create technology mutual funds, allowing private enterprises to fund university research, and creation public-private technology incubators. A separate law (11.080 of December 30, 2004) creates an agency to manage the GoB's industrial policy.

17. (U) Along with these headline measures, the GoB enacted multiple lower profile reforms, including: reduction of taxes on long term investments, measures to improve mortgage market functioning, a program to finance capital equipment modernization and reduction of a financial transactions tax on life insurance.

On the Agenda for 2005  
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18. (SBU) President Lula announced on February 15 his four priority reforms for 2005, including: a second round of tax reform to unify state-level VAT tax rates; labor union reform; reform of the University system; and, regulation/implementation of the PPPs. Only the first three of these would require congressional action.

-- The tax reform would unify the state-level ICMS tax, a VAT with rules and rates that currently vary from state to state. ICMS unification, along with a national-level VAT, formed part of Lula's original 2003 tax reform package, but its consideration was postponed as part of a political compromise.

-- Labor-union reform, as currently envisioned, would revamp the rules for labor union activities but would not modify Brazil's rigid workplace rules, which firms complain is a major disincentive to hiring. Broader labor reform would be postponed until next year (i.e. after the October 2006 election).

-- The university reform measures aim to increase access by Afro-Brazilian students to federal universities through quota systems and grant certain poor students free education at private universities.

19. (SBU) Lula's list of priorities did not include a number of other reform measures currently pending in Congress. These include Central Bank independence, the regulatory agency law (ref E), the second tranche of judicial reform (ref G), a law allowing expanding use of mediation to resolve legal disputes, a micro-credit program, simplified labor and tax requirements for very small businesses and legislation to refine rules against anti-competitive practices in financial markets. The Finance Ministry also has a long list of other reform proposals that have not yet made it to Congress. These include reducing payroll taxes, reform of the tax system for small and medium-sized enterprises, creation of a positive credit reference database, liberalization of the market for reinsurance and creation of a national value added tax (envisioned for 2007). The Secretary of

Economic Policy at the Finance Ministry, Marcos Lisboa, has emphasized to us on multiple occasions the importance he places on maintaining reform momentum in what he views as a long-term reform process. The Finance Ministry accordingly has moved forward with alternate lower-profile and more technical measures, such as the tax rate changes to promote long-term savings -- enacted via decree in mid-2004 -- at points when Congressional action has been slow.

#### Business Priorities

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10. (SBU) CNI's Mendonca told Emboff February 23 that industry's top priorities are labor reform and a comprehensive tax reform. He lamented that labor reform appears to be off the agenda for this year. While he expected the Congress to unify the ICMS tax, Mendonca dismissed this as an isolated effort, far short of the overhaul that industry believes the tax system requires. Mendonca argued that the current system, which consistently taxes production and investment, must move to one that taxes consumption and profits. While there might be consensus that the tax system is broken, Mendonca said, Brazil's high debt service creates a "fiscal straightjacket" that makes overhaul of the tax system a risk to revenues that Brazil can little afford. This means that major tax system changes would likely have to be postponed until debt service levels have been reduced. Mendonca nevertheless argued that Brazil was moving methodically and steadily, albeit slowly, in the right direction, having sustained a process of continual reforms for a decade through three administrations and two very different presidents.

#### Comment

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11. (SBU) The surprise election of dark horse candidate Severino Cavalcanti as Speaker of the House of Deputies appears to have reduced the ambition of the GoB's 2005 reform agenda. Lula's four priorities, only three of which require congressional action, slimmed down what had been expected. Lula notably made no mention of Central Bank independence, a measure Cavalcanti has said he opposes, but which the Finance Ministry was pushing as a priority for the year. While much can change quickly in the world of Brazil's congressional politics, 2005 looks to be a slow one for Brazil's microeconomic reform agenda. That said, we expect the Finance Ministry to find ways to push lower-profile technical measures and maintain positive reform momentum.

DANILOVICH